Aaron Merriman: This is the Passive Income Investor podcast hosted by Matt Doran and Aaron Merriman. This podcast features discussions and interviews related to conservative passive income investing. We focus on long term wealth building and tax efficient income strategies.

So, thank you for joining us today, everybody. Matt and I are really excited about today's topic. We're going to be talking about embracing illiquidity. Embracing illiquidity in our investments, and really not being focused on checking the value of our portfolio, a specific stock, whatever that investment may be. But really looking at thinking about being a long term investor, and focusing on your long term goal and not getting neurotic and thinking about every little thing and what's the value every second. This is Aaron Merriman, and a little bit about LMDG. For those of you that might be joining this podcast for the first time. Lujan Merriman Development Group is based here in Southern California, in Orange County. We're a multifamily real estate investment company. We focus on smaller apartment buildings, typically five to 15 units in really desirable areas here in Southern California. It's primarily coastal property. What we like to do is we buy these great historical buildings, typically 75 to 100 years old; we renovate them to compete with new construction. This allows us to attract great tenants, add a lot of value, and generate some nice yields. Thanks again for joining us today. Matt, tell us a little bit about Sage.

Matt Doran: Yes, thank you very much. This is Matt Doran, Sage wealth planning, which is a registered investment advisory firm domiciled in Michigan. We are a planning centric and tax focused, financial planning firm. We like to do comprehensive holistic planning that examines the various aspects of an individual or family's financial life and the interaction of those aspects and how we can harmonize and make most efficient, all those moving pieces.

Aaron Merriman: Awesome. So, Matt, let's jump into this, embracing illiquidity. It’s not a term that gets thrown around very often. It's something that you and I love to talk about. For me, being a real estate investor, it's about illiquid, and hard to mark to market, so to speak, as you can do. That being said, we do with our investors try to do some updates, and we are very geographically focused, so we can do some stuff to have a high degree of accuracy on the value of those assets. But it's not something where someone can go on their phone and check an app and know, in every millisecond, what the value of something is. So, talk to us from your side. Talk to us a little bit about that, and why it is a good thing. It is a good thing to be in illiquid asset, because of some of the psychological impacts that you can have on long term investing and wealth growth.

Matt Doran: Yeah, I mean, just like everything, the key is balance. I mean, people need liquid investments as well to meet short term cash needs or unexpected expenses that come up or ongoing operational expenses. The problem is, when everything is super liquid, it can encourage the wrong behaviors. So let's back up a little bit and talk about what illiquidity or liquidity actually mean. So liquidity actually refers to how quickly something can be converted into cash, and preferably converted into cash without dramatic fluctuation in value. So we've all heard the terms locked up, tied up, and they're generally associated with something that's negative, but the term that probably isn't as well known, which we call marked to market is how liquid investments work. Liquid investments which are marked to market, at least every day, and generally, hundreds of times during the day are reflecting what a particular asset or investment could be sold for converted to cash quickly. How much would it be worth if you converted it to cash right now, and in investing that can be counterproductive because success in investing requires having faith in the future;

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It time for things to develop the reliance on ingenuity and innovation and population growth and new products, new markets, new efficiencies, new technologies, new synergies. A rising standard of living that's happening across the globe and faith in the future requires managing the present. In order to get the outcomes we're seeking, we need to manage how we're feeling in the present, which isn't always good. So the benefit of having a balance of liquid and illiquid investments is that the ones that aren't marked to market, in other words, the ones that can't be readily converted to cash, in our minds hold their value in a more stable way. They don't prompt us to run for the exits, either to cash in on a short term profit, or to run for the exits, because we think it's going lower in value. We just think of them differently, because they're not as accessible.

Aaron Merriman: Right. From our side, we see that in the psychology of different investors that we have, because you have investors that are more focused on getting that rental income distribution or whatever type of distribution that might be as quickly as possible and they're really ignoring the value creation piece that is harder to quantify. In our business, that's something that is a big part of our business. I mean, we have a property right now that we're into it for 4.2 million, we've owned it for a year, and we have an offer for five and a half million dollars. That property has not generated $1 of positive cash flow, it's 100% value creation.

Now, that's an extreme example, for our business. But there there's investors that totally get that and understand that, and they're fine with that and there's others that would prefer something that allows them to step into more of a either immediate or as quickly as possible distribution model. And they're getting something and it kind of ignoring that value piece.

Matt Doran: Yeah. And let's face it, I mean, holding periods have gotten shorter on everything. My parents bought their first home, I don't know the early 70s. And it was a ridiculously low amount by today's standards. Well, inflation is part of what pushes the value of hard assets up over really long periods in and equities, including real estate, and stocks are good inflationary hedges, but holding periods matter. We talked about it in a previous episode about the tax treatment, but now we're talking about it in terms of giving an asset time to do what it’s supposed to do. I think that as information moves faster, particularly in the world of investments, it encourages people to make decisions based on really short term things.

That why I say again that illiquidity is your friend, if it allows you to ignore whatever today's value is, and allow the asset to perform over time as it's intended to. So quickly, business cycles are just that, they’re cycles. While those cycles have definitely lengthened, technology has aided that a lot inventory control and warehousing and, certainly, cycles have grown in their length, but they're still cycles, they're longer, they're not extinct. When you get into an illiquid investment, I personally believe that the private markets are a little better structured to promote good behavior in this area, you're hiring a manager. You’re hiring a manager for a skill set and expertise that they've developed over time and they need time to put those skills to work to identify opportunities, to execute on opportunities, which often present themselves in the negative or the down part of a cycle.

Not having the value reported back to you multiple times a day, or every day, encourages people to say, I've hired somebody who's skilled in this area to do what they do, and let them do it. Then the other part about the private markets is, they gain commitments from investors.

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On the front end, they know that they have what we would call dry powder. They know they have resources to work with, but they don't call in that dry powder until it can be effectively put to work. It gives the manager whether it's you or somebody else in a different type of investment arena, it gives them the opportunity to go looking for opportunity, and only call for the investment when they know they can productively deploy it. I think that's set up for better psychology.

Aaron Merriman: That's a great point. Thanks for joining us today. You're listening to the Passive Investor Podcast with Matt Doran and Aaron Merriman. Today we're discussing the importance of embracing illiquidity. Something that you touched on their Matt too that we talk about tax a lot, and it's something that I think a lot of people don't really think about too much when they go into an investment. Back to my earlier comment about the value appreciation, whether it's now a stock is obviously liquid, but at least at this point, you're not paying tax on appreciation.

If a stock or a piece of real estate or whatever, a private investment, with a PE firm or a company, if that thing's going up in value, you're not paying tax on that. It a good strategy, if you are looking for tax efficient stuff, versus investing in something that's turning over a lot, and maybe it's less than a year, and so it's being taxed at ordinary income. So that's something that we talk about as well when we're educating folks about, what we do, and the different kinds of properties that we'll go into, but you're right, as far as being able to be nimble and knowing, we really know the markets that we invest in, we're hyper focus. So, we know if something's a deal or not a deal, and we're not going to overpay, and sometimes that means having cash on the sidelines. When you buy wrong, it can sometimes take a really long time for the grass to grow. Think about people that were buying real estate, at least in my area, in 2007, eight and nine. I mean, it took a long time for those things to come back.

Matt Doran: Yeah. In my world, I refer to this phenomenon is the difference between building wealth and making money. I would tell you that a lot of what is 'investing behavior' is not investing at all, its speculation. When somebody buys something, regardless of what it is because they think it's immediately going to go up in price, that's a more speculative activity, versus an investment, which is because there's a long term trend in place, or there's a technology or an improvement, or some positive force that will change the landscape. That's why I say successful investing is about having faith in the future and those trends that support wealth creation, rather than XYZ stock just had a great announcement, and I think it's going higher. I'm not opposed to those things, either. I just don't want to confuse them. There's a difference between building wealth and making money. We go to work every day to make money. When we put our money to work to build wealth, that's a different activity.

Aaron Merriman: Yeah, and there's been so much of that kind of, you're calling it speculation. A lot of it to me is gambling. There's been a lot of that over the last year with some of these stocks. It's almost like, if you want to do it, that's fine. But don't bet the farm on it, it needs to be a pretty small allocation of your overall strategy. I mean, touch a little bit from your side and when you're talking to clients about how you coach them on thinking about this is long term, or you may be already retired, maybe you're retired and 10, 20, 30 years, but this is the mindset that I want you to have not, "Hey, check my app every 10 minutes."

Matt Doran: Yeah, I mean, they're all kinds of rules of thumb out there.

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A popular rule of thumb used to be that if you subtracted your age from 100, you'd wind up with the amount of stocks you should own or whatever. I think everybody's circumstances are so different that rules of thumb can be harmful, but if we talk about when the need to access the capital is likely to be, it creates a different framework for how money ought to be invested. I've had recently a number of conversations with folks who've worked hard saved well, invested successfully, and have built wealth that will last well beyond their own lifetime. So why would we be investing it based on their age? If the ambition is to pass it to future generations, shouldn't that have a role in what kind of investments the client holds? Once again, harkening back to a previous episode about tax treatments and step up in cost basis and structures that create efficiencies, I think wealth creation and the transfer of wealth that has been created, have more to do with when the capital might be needed than anyone's age. A lot of wealth has been built in this country, through illiquid assets, like land and homes and commercial buildings. If I could go back in time and buy property in some really desirable locations, and certainly I do that, but it doesn't involve checking the value every single day and seeing what I could cash out for.

Aaron Merriman: That's a great point. It does, it does feel like a lot of the older -- I don't know if older is the right term, but a lot of the methodologies that we all kind of grew up with, through college and Post College was preparing for your income or your wealth to go down when you retire. At least with a lot of investors that I have, it's the exact opposite of that. So why would you take this strategy of dialing everything back? Think about your legacy, think about your heirs, or whatever that might be, whether it's through a foundation, or charity, like why not set everybody up the best way and not just shut everything down, because you're not working anymore. That’s a good point.

Matt Doran: I think there's an interesting inflection point too for people who've worked hard, live below their means and put resources to work for the future, by the time they walk away from the income that comes from work, the assets that they've accumulated are substantial enough to replace or maybe even improve that income. If the assets are then producing income, why would we be looking to liquidate those assets? That's the whole point is that the resources now produce income instead of your effort doing it and we go to work every day to make money. Once again, the difference between building wealth and making money, assets can produce income and so I think the North star is building assets and net worth rather than buying something at this price and selling it at that one. While we're on that topic, I mean everybody's heard buy low sell high but the opposite is much more common because of the liquidity that comes with investing today. I mean, buy something and sell it two seconds later. That’s a recipe for emotion to play an outsized role in the equation

Aaron Merriman: Yeah, that's so true. As we kind of jump into parting thoughts here, I think a lot about just the properties that we buy. Most of the properties that we buy, they’re off market or they’re some kind of pocket listing, but it's a lot of families. Dad and mom were buying properties maybe as far back as the 70s and the 80s and the 90s and they got comfortable with an area that happened to be where we like to invest.

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They’ve really built up some amazing portfolio over the years. They just continue to operate and grow it and they've either passed or they're elderly and the kids don't want to do it, they'd rather just cash out. It’s a lot of that kind of discipline around obviously, again, it's real estate. It's more illiquid than publicly traded security. But it's that discipline of seeing an opportunity, growing it slow year over year, and all of a sudden, they've got this -- we've seen 20 $30 million portfolios that have just been built up over 40 years that as they sit are creating some nice income for somebody, but there's just this huge value that is ready to be unlocked. So, parting thoughts, Matt.

Matt Doran: Know thyself. Illiquidity is your friend, if you're apt to feel the need to react to news and events. Again, I said this at the outset, balance is the key, we need both. The problem is in the modern world, there's probably too much focus on liquidity, and less in the equation that is illiquid. I believe that they work best together.

Aaron Merriman: Great point. Well, thank you for joining us everybody today as we talk about embracing illiquidity. Join us next time as we discuss tax efficient retirement investing.

For more information on LMDG, you can visit lmdg.net, and for examples of some of our projects or see more videos from Matt and I, you can also visit youtube.com/lmdgre, or you can email me directly at Aaronmerriman@lmdg.net. For more information on Sage Wealth Planning, you can visit sagewealthplans.com. Or you can email Matt directly at mdoran@sagewealthplans.com.